SENATE TAXATION
EXHIBIT NO. 9
DATE 3-26-07
BILL NO. SB-120

Mr. Chairman and members of the Senate Taxation Committee:

My name is Brian Pedersen. I am a Managing Director with Alvarez and Marsal Taxand and I am based in Seattle, Washington. I am also a graduate of Capital High School in Helena and the University of Montana in Missoula. I have been practicing in the area of state and local taxation for 22 years, including a previous role as the National State Income and Franchise Tax Leader and the Northwest State and Local Tax leader for Big 4 accounting firms. Thank you very much for the opportunity to share some thoughts regarding SB-120, the REIT Tax Bill.

The General Tax Structure of REITs.

- REITs were created by federal legislation in 1960 to encourage individuals of average means and sophistication to invest in professionally managed real property portfolios

- For tax purposes, REITs are entitled to deduct dividends paid to shareholders (and, in fact, must distribute at least 90% of taxable income to shareholders)

- REITs are not pass-through entities like partnerships and LLCs since they are taxed on any undistributed income at the REIT level

- Shareholders of REITs are subject to income tax on dividends received as they would be on other corporate distributions

- Every state imposing a corporate net income tax, with the exception of New Hampshire, follows the federal treatment of REITs

- Many REITs have taxable REIT subsidiaries (TRS) that are taxed just as any other corporation. Accordingly, many REITs own TRS subsidiaries that pay significant federal and state income taxes

- REITs pay many state taxes directly—property taxes, employment taxes, sales and use taxes and other taxes are imposed directly upon REITs

In short, REITs were designed to allow individuals to own a share of diversified real estate portfolio. To that end, REITs are limited as to the type and amount of property that they own, must distribute at least 90% of their taxable income to shareholders, must have a minimum of 100 shareholders and must meet various other requirements.

For state income tax purposes, virtually all states follow the federal income tax treatment of REITs. Accordingly, such states allow the dividends paid deduction (DPD) at the REIT level and tax the recipients on REIT dividends received. Individuals are generally taxed on dividends based on residence. Therefore, Montana residents that receive REIT dividends must pay Montana income tax on those amounts.

Recent legislation in other states relating to REITs is largely focused on "captive REITs". Captive REITs are REITs that are effectively controlled by a single or commonly controlled group of corporations. Many states believe that such structures allow a single taxpayer to enjoy the benefits of a REIT structure when such structures were designed to allow a broad cross-section of individuals to invest in real estate. Such legislation typically seeks to deny the DPD to captive REITs—unlike SB 120, which seeks to deny DPD treatment to *all* REITs, not merely captive REITs.

Effects of SB 120

SB 120 would have several negative effects.

SB 120 would put Montana tax treatment of REITs at odds with the federal tax treatment of REITs and virtually every other state's treatment of REITs. The perceived tax issues that SB 120 is designed to address are simply not reflected in other states' approaches to REITs. In fact, if Montana diverges from the mainstream, such treatment leads to multiple problems for taxpayers:

- Double Taxation—disallowing the DPD can result in double taxation. The REIT would be taxable on its income at the REIT level, and non-resident individuals would still pay tax on REIT dividends.

- Compliance Complexity—when states diverge from federal and other state tax treatment of items, it is difficult for taxpayers to track and comply with the various differences. Taxpayers must expend extra resources, and states must spend extra effort assisting such taxpayers and ensuring that such taxpayers comply with the different laws.

SB 120 would reduce Montana's competitiveness. When taxpayers, including REITs, are determining where to invest capital and other resources, the state tax burden is a prominent factor in the decision. If SB 120 is enacted, the tax imposed at the REIT level will be a significant expense *not found in other states* and will severely negatively impact decisions to invest in Montana.

SB 120 would negatively effect investor decisions. When investors are making REIT investment decisions, the fact that REITs that do business in Montana pay taxes that virtually no other state imposes make such REITs undesirable to investors. Further, under SB 120, Montana residents that receive REIT dividends would be allowed tax relief to the extent that the REIT paid Montana tax. This is, practically speaking, of virtually no benefit, as REITs have no existing reason or ability to track the residence of their shareholders. As such, Montana residents would likely still pay tax on dividends from REITs that do business in Montana.

Simply put, any perceived benefits of SB 120 are far outweighed by its far-reaching negative effects.